June 18, 2024

Dr. Klaas Knot
Chair
Dr. John Schindler
Secretary General
Financial Stability Board (FSB)
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Consultation Report: Liquidity Preparedness for Margin and Collateral Calls

Dear Drs. Knot and Schindler:

The Institute of International Finance (IIF) and its members[1] appreciate the opportunity to comment on the FSB's consultation on Liquidity Preparedness for Margin and Collateral Calls (Liquidity Consultation), which was published on April 17, 2024. The IIF supports the work of the FSB to enhance the liquidity preparedness of non-bank market participants for margin and collateral calls in centrally and non-centrally cleared derivatives and securities markets.

We support the FSB's calls for central counterparties (CCPs) and intermediaries to play a role in helping their clients better prepare for spikes in margin and collateral calls by providing more transparency on their margining practices. Greater transparency into CCP margining practices would promote market participants' operational efficiencies and preparedness. The FSB could also call on CCPs to share more information with one another and with market participants on their stress testing scenarios and to provide more detail regarding their margin and collateral models.

***Overarching Comments on the Liquidity Consultation***

Overall, we believe that the Liquidity Consultation offers helpful and appropriate policy Recommendations with respect to managing and mitigating exposures to spikes in margin and collateral calls. We appreciate that the standard-setting bodies (SSBs) are tasked with developing appropriate requirements for their sector based on the FSB recommendations and that the FSB Recommendations are intended to be applied proportionately to reflect the underlying risks of different types of non-bank market participants.

We appreciate the focus in Section 2.4 of the Liquidity Consultation on proportionality and materiality and the recognition that non-bank market participants represent a broad range of sectors with different liquidity risk management needs and practices. The important principles of proportionality and materiality should be emphasized particularly with respect to funds, which vary significantly as to the level of risks

[1] This consultation response primarily reflects the views of the (buy-side) members of the IIF's non-bank financial intermediation working group.

they present, including but not limited to the risks associated with high degrees of leverage and the use of derivatives. Consistent with the principle of proportionality, only funds that pose higher risks should be in scope of the Recommendations. In addition, the FSB Recommendations should apply at fund level and not at entity level with respect to asset management activities, as risk management and stress testing generally are conducted at fund level.

In designing a final set of FSB Recommendations, we encourage the FSB to differentiate among non-bank market participants that are already highly regulated and subject to comprehensive supervision and those market participants that are not subject to comprehensive regulatory and supervisory frameworks (or in some cases, any regulatory or supervisory framework). This differentiation is noted in the Background to the Liquidity Consultation but could be more fully developed in the Recommendations and supporting narrative. Currently, regulated market participants are required to comply with a number of the FSB Recommendations and their liquidity and collateral management frameworks are subject to robust supervision and oversight. Accordingly, the FSB should focus its primary attention on market participants that are not subject to comprehensive regulation and supervision (or any regulation or supervision), as a lack of regulatory or supervisory oversight may lead to shortcomings in liquidity and collateral management practices that may increase risks in the markets.

To mitigate the procyclical effects of spikes in margin calls in times of market stress, CCPs and clearing houses should be encouraged to coordinate their efforts and to provide greater transparency into the impacts of netting, which facilitates greater capital and collateral efficiencies. CCPs should also be encouraged to avoid sudden and significant (and, thus, procyclical) changes and cliff effects in margin and collateral requirements and practices, to the extent consistent with sound risk management and CCP financial and operational resilience. Greater transparency from CCPs on risk models, stress testing parameters and scenarios would be particularly beneficial for market participants, including the buy-side, in order to optimize their anticipation of and preparation for margin calls. In addition, clearing members should be encouraged to provide the maximum feasible notice periods in advance of the recalibration of margin calls.

We encourage the FSB to play an important coordinating role to play with respect to the various consultations underway by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the Committee on Payments and Market Infrastructures. These consultations focus on important enhancements to margin and collateral models that would help to meet a number of the goals of the FSB Recommendations in the Liquidity Consultation. Alignment of the work underway through these SSBs would help provide clarity on expectations for liquidity preparedness and would avoid divergent guidance to market participants that could give rise to inefficiencies in liquidity and collateral risk management. Recognizing the potential for market destabilization when credit and counterparty risks are not well managed, the FSB could consider the need for additional guidance to banking regulators and supervisors on the management of these risks.

***Specific Comments on the Liquidity Consultation***

**Recommendation 1** calls on market participants to incorporate the assessment of liquidity risks arising from margin and collateral calls in their liquidity risk management and governance frameworks. We agree fully with this Recommendation for funds that engage in higher risk activities.
We would urge the FSB to incorporate the important principles of proportionality and materiality explicitly in this Recommendation, as well as throughout any guidance developed by the FSB on the broader topic of liquidity preparedness for margin and collateral calls. As noted above, in the case of asset management activities, this Recommendation should be applied at fund level and not at entity level, with a focus on funds that engage in higher risk strategies, such as the extensive use of derivatives. Funds in scope of Recommendation 1 (as well as the other FSB Recommendations) could be identified through stress testing exercises.

**Recommendation 2** states that market participants should define their appetite for liquidity risk arising from margin and collateral calls and establish contingency funding plans to ensure that liquidity needs can be met, including under extreme but plausible stressed conditions. As discussed in greater detail below with respect to Recommendation 5, it is not feasible for market participants to define *ex ante* with any level of certainty extreme but plausible scenarios given the lack of certainty as to what will occur in practice *ex post .* Accordingly, the expectation that market participants ensure that liquidity needs can be met, including under extreme but plausible stressed conditions should be qualified by adding the words *'to the extent possible*' after the word 'ensure'.

**Recommendation 2** should reflect that liquidity risk appetites and contingency funding plans will depend on specific fund design features and characteristics, including the use of leverage. Recommendation 2 should be applied at fund level, with a focus on funds that engage in higher risk strategies, such as the extensive use of leverage and/or derivatives. Moreover, regulated non-bank market participants generally are already subject to regulation and supervision with respect to liquidity risk and supervisory expectations around the development of contingency funding plans. The narrative around Recommendation 2 could better reflect the existing comprehensive regulatory and supervisory landscape in most jurisdictions.

We would clarify in the example provided in Annex 3 (which appears to have been drafted with sell-side models in mind) that fund managers generally assess risk at the fund level, as opposed to by business line.

**Recommendation 3** calls upon market participants to regularly review and update their liquidity risk frameworks to ensure that liquidity risks are robustly managed and mitigated, particularly under extreme but plausible stress scenarios. We reiterate our comments regarding the difficulty in defining *ex ante* extreme but plausible stress scenarios given the inherent uncertainties as to outcomes. We encourage the FSB to qualify the suggestion that market participants can 'ensure' that liquidity risks are robustly managed and mitigated under a range of market conditions by stating that market participants should do so to the extent 'feasible' and/or use their best efforts to manage and mitigate liquidity risks under stressed market conditions.

Moreover, the scope and frequency of reviews and updates to liquidity risk frameworks may differ depending on the fund portfolio and the risks it presents. For example, less frequent or less intensive reviews may be needed for unleveraged funds.

**Recommendation 4** emphasizes the need for liquidity stress tests and scenario design that take into consideration both normal and stressed market conditions and suggests that authorities could provide guidance regarding scenarios. We support additional guidance regarding scenarios from financial authorities, as that guidance can help market participants plan for liquidity needs under different market conditions, including both normal and stressed market conditions. However, authorities may be reticent to provide guidance because of concerns that specifying scenarios may lead market participants to rely exclusively on those scenarios, to the exclusion of other equally important scenarios or may lead to moral hazard. Therefore, we would encourage the FSB to call on CCPs as well as financial authorities to provide guidance to market participants on appropriate scenarios. CCPs should also be encouraged to share their stress testing frameworks with other CCPs and, ideally, the wider range of market participants, in order to help facilitate the continued evolution of sound practices for margin and collateral stress testing.

The narrative around Recommendation 4 should note that liquidity stress tests should take into consideration fund design with a focus on funds that engage in higher risk strategies, such as the extensive use of leverage and/or derivatives. Simpler stress tests may be appropriate for less risky funds that do not take on high levels of leverage.

Including in stress scenarios the actions of counterparties and other market participants experiencing liquidity stresses that could adversely affect the market participant can be extremely challenging. Market participants generally do not have information about the liquidity stresses experienced by other market participants or counterparties. Rather, relevant market information may be in the hands of regulators and supervisors and the FSB could consider whether it would be helpful to encourage those authorities to provide appropriate and anonymized information from their market monitoring activities to the market more broadly in a careful and considered manner that does not give rise to market disruptions or panics.

Whether stress tests are conducted at an aggregate or individual entity level will depend on the structure and risk management framework of the market participant and a degree of flexibility should be granted to market participants in designing stress tests. As an example, for fund managers, stress tests generally are conducted at the individual fund level. The aggregation of individual fund level stress tests likely would produce results that are not actionable or meaningful and we would not support a recommendation for such aggregated stress tests in the case of fund managers. Accordingly, Recommendation 4 should apply at fund level, with a focus on funds that engage in higher risk strategies, such as the extensive use of leverage and/or derivatives.

In Annex 3, the illustrative example under Recommendation 4 states that in the calibration of liquid assets needed to *ensure* that a market participant can meet its projected cash outflows under the relevant scenarios, the market participant will *ensure* that assets can be accessed and liquidated within the projected time horizons. We reiterate our comment regarding the need to qualify the use of the term 'ensure' with words to the effect of 'to the extent possible'.

**Recommendation 5** states that robust stress testing should analyze a range of extreme but plausible liquidity stresses caused by changes in margin and collateral calls. We encourage the FSB to not underestimate the value of standard scenarios based on historical data. Extreme but plausible scenarios can be difficult to define *ex ante*; for example, it would have been extremely difficult to predict the March 2022 nickel trading suspension and cancellation of trades. Moreover, testing a range of scenarios that may be highly unlikely to manifest may divert resources from an analysis of more likely market stresses and lead to inefficiencies in liquidity risk management as a result of excessively high estimates of the need for cash and highly liquid assets.

The inclusion of changes in margin and collateral calls in stress testing depends on greater transparency from CCPs and clearing members regarding their risk models and simulation tools, as well as longer notice periods to clients before the recalibration of margin and collateral requirements.

The narrative included in Recommendation 5 asks market participants to consider whether they participate in crowded strategies or concentrated market segments, and when this is the case, to incorporate an estimate of the incremental market impact and liquidation costs. We note that it may be very difficult for market participants to anticipate the reactions of other market participants, especially in stressed or volatile markets. Therefore, we ask the FSB to qualify the last sentence of the narrative under Recommendation 5 by stating: Where this is the case, they should*, to the extent possible,* incorporate an estimate for the incremental market impact and liquidation costs, based for example on reduced market depth and wider bid-ask spreads associated with extreme stressed conditions.

**Recommendation 7** states that market participants should maintain *sufficient* levels of cash and readily available as well as diverse liquid assets and establish appropriate collateral arrangements to meet margin and collateral calls. We believe that the standard should be *appropriate* levels of cash and readily available and diverse liquid assets to meet margin and collateral calls. It is very difficult to make an *ex ante* assessment of whether a particular level of cash or liquid assets will be sufficient, particularly under stressed market conditions. An *ex post* assessment of the adequacy of liquid assets or collateral arrangements can be a helpful input to a market participant's liquidity stress testing or scenario analysis exercises going forward. However, we would not support the imposition of a mandatory cash buffer for funds, as this would be inefficient and uneconomical as it would be extremely difficult to calibrate with precision and could impact negatively fund performance.

We strongly support the FSB's reference to non-cash collateral to meet margin calls, including for variation margin. The FSB should consider further support for the expansion of the acceptance of non-cash collateral to support market functioning and avoid 'dash for cash' scenarios, which may contribute to systemic risk.

We reiterate the need to qualify the use of the term 'ensure' in the narrative accompanying Recommendation 7 with words to the effect of 'to the extent feasible', specifically as it relates to ensuring a sufficient quantity of collateral to meet margin and collateral calls in the required timeframe and likely value. The same qualification should be added to the statement that market participants should ensure that their liquid asset and collateral do not exhibit a significant correlation with the value of their collateralized portfolio in a way that would undermine the effectiveness of the protection against future liquidity demands, which are largely unknown.

**Recommendation 8** notes the need for active, transparent and regular interactions with counterparties and third-party service providers in collateralized transactions to ensure adequate operational resilience with respect to spikes in margin and collateral calls under stressed conditions. We agree with this recommendation and would add in the narrative under Recommendation 8 a statement that counterparties and third-party service providers should clearly advise market participants of notice periods so that market participants may better anticipate their liquidity and collateral needs and provide for those needs in a timely manner.

With respect to the consideration of how the counterparty risk management practices of market participants' counterparties may respond during times of market stress, we reiterate our comments regarding the difficulty of making these assessments, particularly on an *ex ante* basis. We suggest the addition of the words 'to the extent feasible' in this narrative.

The illustrative example under Recommendation 8 in Annex 3 suggests quarterly reviews with prime brokers and largest counterparties, which may not always be necessary or appropriate. We encourage a more flexible and proportionate approach to these reviews by stating that such reviews should be conducted 'as appropriate'.

We appreciate the opportunity to comment on the Liquidity Consultation and we would welcome further dialogue and discussion of these issues with FSB members and Secretariat.

Respectfully submitted,

Mary Frances Monroe
Director, Institute of International Finance